

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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FCC - MAIL ROOM

In the Matter of)
Simplification of the)
Depreciation Prescription)
Process)

CC Docket No. 92-296

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

**Reply Comments
of the
Minnesota Department of Public Service**

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Introduction

In its December 29, 1992 Notice of Proposed Rulemaking (NPRM) in CC Docket No. 92-296, the Federal Communications Commission (FCC or Commission) invited comments on proposals for depreciation simplification. It offered four options intended to simplify the current depreciation prescription process.

The basic factor ranges option establishes ranges for the basic factors that determine the survivor curve, projection life and future net salvage parameters used by the companies' in their depreciation rate formulae. Although the FCC would retain its use of the current depreciation rate formula, it would eliminate the need for carriers to perform detailed studies to support the factors they propose and thereby effectuate cost savings and depreciation simplification.

The depreciation rate ranges option simplifies the depreciation process by establishing ranges for depreciation rates. Under this alternative, basic factors would not be used to derive the parameters for the depreciation rate formula, and the depreciation rate formula would not be used to determine depreciation rates.

The FCC's third proposal, the depreciation schedule option, effectuates simplification by creating a depreciation schedule for each plant account. The schedule would be based upon a Commission-specified service life, retirement pattern, and salvage value for each account. The schedule would be applied to the investment amount in order to determine the depreciation expense for the carrier.

Under the price cap alternative, applicable only to price cap-regulated carriers, depreciation rates could be filed by the carriers without the necessity for supporting data. Based upon the comments it received on the proposed rates, the FCC would then authorize final depreciation rates.

In addition to its request for comments on the four depreciation alternatives, the FCC requested comments on simplification of the salvage process and its exclusion from the depreciation determination procedure. Commenting parties discussed the removal of salvage from the depreciation process and the booking of the cost of removal and salvage as current period charges.

Summary

In Response to the Commission's Notice of Proposed Rulemaking (NPRM), a variety of comments were submitted. Although most parties agreed that depreciation simplification would be useful, they generally disagreed as to the nature or extent of the changes that would be required. For the most part, local exchange carriers (LECs) endorsed the price cap carrier option because it would allow LECs the most freedom to adjust depreciation rates and to thereby recover more quickly the costs associated with their investments. Further, the LECs would not, for the most part, change the present method of incorporating net salvage into their calculation of depreciation expense.

By contrast to the LEC proposals, the regulatory community generally supports the existing depreciation prescription process. This is because the proposed simplification mechanisms would eliminate needed regulatory safeguards and would not generate the anticipated cost savings which, to a large extent, drive this desire for simplification. In addition to the exaggerated measure of cost savings, regulators responding to the NPRM also cite as premature, the LECs' assertion that the marketplace is sufficiently competitive to protect ratepayers.

Although state regulators would, in general, prefer to retain current depreciation

I. The markets served by local exchange carriers are not universally competitive and do not lend themselves to the depreciation flexibility advocated by the carriers.

The foundation for the carriers' proposals that the establishment of depreciation rates should be simplified is their assertion that virtually all of their markets are equally competitive although this claim is widely disputed by the regulatory agencies that have responded to the Commission's NPRM. The New York Department of Public Service opposes simplification options because they reduce oversight of the LECs before the competitive market has developed enough to protect ratepayers. Moreover, it cites the necessity to provide regulatory oversight as long as ratepayer choices are limited to a single monopoly provider of the service.¹ The Minnesota Department of Public Service (MN DPS) concurs with the New York Department of Public Service. Indeed, the FCC should not base fundamental changes in depreciation practices upon LEC assertions of market competitiveness that are neither universally present nor supported by conclusive evidence. Unnecessary liberalization of depreciation practices has the potential to adversely affect LEC rates as well as company decision-making and investment decisions.

Notwithstanding claims to the contrary, LEC prices are ultimately linked to depreciation expenses and are not mutually exclusive events as some carriers seem to suggest. This same concern is echoed by State Consumer Advocates of the District of Columbia, Florida, Indiana and Pennsylvania (SCA). According to SCA, even though the price cap mechanism does not automatically allow carriers to pass through depreciation charges to ratepayers, depreciation expenses significantly affect consumer rates.²

Only rarely are the depreciation expenses proposed by the LEC consistent with those advocated by the regulatory agency. For example, in Minnesota, U S WEST Communications, Inc. (USWC) proposed depreciation rates for its digital switch and buried metal cable accounts for 1992 which would increase depreciation expense by some \$5.4-million more than the depreciation rates authorized by the Minnesota Public Utilities Commission. The MN DPS is concerned that the various forms of depreciation

¹ New York Department of Public Service, Comments at p. 3.

² State Consumer Advocates of the District of Columbia, Florida, Indiana and Pennsylvania, Comments at p. 3.

simplification proposed by the FCC will destroy the balance represented by the current process and result in an adverse impact upon consumer rates. Clearly, the price cap carriers option comment period will not provide the necessary interaction to maintain this balance.

The Commission should select the depreciation option that best insulates customers from undue price increases resulting from the LECs' increased control over their depreciation practices. So-called competitive forces are not presently sufficient to regulate carrier behavior absent continued regulatory oversight.

II. A limited application of the basic factors range option is the appropriate mechanism by which to introduce depreciation simplification.

Many of the Comments submitted by state regulators in this proceeding express skepticism with the four options advanced by the FCC and argue that any new depreciation mechanism should be approached with caution and should be tested on minor accounts to determine its effectiveness and minimize any unacceptable consequences. Consistent with this approach, both the California Public Utilities Commission and the New York Department of Public Service advocate that the FCC adopt the basic factor range option for the limited purpose of its application to minor plant accounts. In this way the impact of any simplification efforts upon the depreciation process will be minimized.⁶ The Minnesota Department of Public Service shares the concerns expressed by these states and recommends that the FCC select the basic factor range option as the least objectionable of the four alternatives, but that it confine its initial application to minor accounts in which the benefit of utilizing the suggested ranges clearly outweigh the cost of doing so.

U S WEST Communications, Inc. and Bell Atlantic argue that unless a single depreciation methodology is applied to all accounts the expected savings will not materialize.⁷ These arguments are not persuasive since the LECs have failed to demonstrate that depreciation simplification applied to all plant accounts will generate

⁶ California Public Utilities Commission, Comments at pp. 2-3, New York Department of Public Service, Comments at p. 9.

⁷ U S WEST Communications Inc., Comments at pp. 10-11, Bell Atlantic, Comments at pp. 10-11.

savings that surpass the depreciation savings that result from the current depreciation practices and their applications.

Central office equipment (COE) and outside plant (OSP) accounts represent the majority of a LEC's investment, thus even a small variation in the depreciation factors applied to those accounts can distort earnings and result in a mismatch of expense and plant utilization. As demonstrated by the LEC Comments, there are a wide variety of operational styles. For example, one LEC may choose to retire its plant more aggressively than another because an opportunity exists to provide additional profitable services. However, simply because the replacement of an investment is economically sound for one LEC, it is not necessarily so for the next. Consequently, the depreciation rates for one LEC may fall outside what may prove to be a reasonable range of rates for another carrier.

When investments in accounts are small and depreciation rates have remained fairly constant, the effect of a depreciation rate change should not be material. The same cannot be said for a major plant account. In the case of major accounts, the impact on the company's earnings resulting from mismatched expense and plant utilization can be harmful to ratepayers.

III. Salvage simplification should be limited to minor accounts that are not experiencing significant technological change.

In response to the Commission's request for comments on the issue of salvage simplification procedures, members of the regulatory community generally supported current period accounting of salvage and the costs of removal. According to the New York Department of Public Service, the removal of net salvage would reduce depreciation reserve imbalances which are currently inflated by projections of significant expenditures for outside plant removal costs.⁸ Similarly, the SCA argues that a large part of the current depreciation process could be eliminated by current period accounting of salvage and the costs of removal.⁹

⁸ New York Department of Public Service, Comments at p. 2.

⁹ State Consumer Advocates of the District of Columbia, Florida, Indiana and Pennsylvania Comments at p. 30.

Reducing large negative net salvages to zero would reduce projected reserve deficits, particularly in many of the distribution plant accounts. If, for example, the negative future net salvage for USWC's Minnesota buried metal cable account would be reduced from 13% to zero, depreciation expense would be reduced by some \$6.1-million. This would have a favorable impact (reduction) of about \$5.3-million on Minnesota intrastate rates. Moreover, removal of the 13% negative salvage in the buried metal cable account, eliminates approximately \$71.7-million that would otherwise be removed through depreciation accruals. USWC estimated a 1992 reserve deficit in the buried metal cable account of about \$67.4-million. As this example demonstrates, removal of net salvage can have beneficial near-term impacts for ratepayers, while removal of large negative net salvage values will reduce reserve deficits.

In the State of Minnesota, negative future net salvages are generally granted to USWC based upon the company's experience with the cost of removal. As such, future net salvages are supported with the best available information. Although future cost of removal and salvage values can only be estimated, making the inclusion of net salvage speculative at best, more weight is given to recent experience. This balance between experience and estimates serves as a reasonable basis for accepting estimates of future net salvage. USWC's 1992 estimated reserve deficit of \$67.4-million could negatively impact its earnings if current period accounting were used to recognize significant costs of removal.

The current period accounting for salvage costs and the cost of removal is acceptable under Generally Accepted Accounting Procedures when salvage and the cost of removal are immaterial or when estimates involve a wide margin of error. For many accounts, the removal of net salvage from the calculation of depreciation expense is appropriate if the estimated future net salvage is close to zero. However, such accounts as motor vehicles, work equipment, buildings, and many outside plant accounts have significant salvage values, often in excess of plus-or-minus ten percent. As long as net salvage estimates can be supported, salvage and costs of removal should be included in the determination of depreciation rates. In this way, the impact of any salvage costs and/or the costs of removal is evenly distributed over the useful life of the associated investment so as not to distort LEC earnings.

IV. The three-way meeting provides necessary regulatory oversight and contributes significantly to the effectiveness of the regulatory process.

The current depreciation prescription process which incorporates the three-way meeting provides a flexible format to determine depreciation rates. This process was generally endorsed by regulatory agencies responding to the FCC's NPRM. California regularly participates in three-way meetings and states that the cooperative effort has been mutually beneficial.¹⁰

It is true that one of the parties may occasionally frustrate the negotiations process represented by the three-way meetings. However, If the effect of depreciation simplification undermines the regulatory review and analysis, then the occasional frustration that may arise from current practices is offset by the resulting benefits of the process. A comparison of USWC's proposed depreciation expense for its digital switch and buried metal cable accounts with the authorized rate was discussed earlier in these Reply Comments. It is reasonable to assume that reduced regulatory oversight will mean higher depreciation expenses and concomitantly higher consumer rates.

Absent the three-way meeting process and reduced FCC involvement, additional effort may be required by the states in their evaluation of LEC depreciation procedures. Thus any savings the LECs anticipate from the federal jurisdiction may be expended in their justification of state proposals. According to the California Public Utilities Commission, any simplification adopted by the FCC will not significantly reduce depreciation study expenses for telephone companies because a formal application is required every year.¹¹ In many instances, life and salvage parameters accepted by the FCC are employed by state commissions for intrastate depreciation certification.

Minnesota's experience in three-way meetings has largely been one of cooperation and compromise by all parties. Minor accounts are usually identified early in the process, and relatively little time is spent negotiating their life and salvage values. Carriers must be required to support their proposals, and the three-way meeting offers a workable way for this to be accomplished.

¹⁰ California Public Utilities Commission, Comments at pp. 1-2.

¹¹ California Public Utilities Commission, Comments at p 2.

Conclusion

Depreciation simplification has been advocated as a way to streamline depreciation procedures and to generate cost savings at the same time. This fact is largely disputed by the state regulatory community. In its evaluation of alternative depreciation practices the FCC must recognize the difference between the LEC perspective and the viewpoint of state regulators.


Depreciation reform must be approached cautiously. The current practices involving three-way meetings provide a useful procedure by which to balance the interests and concerns of carriers and regulators.

The Commission has requested Comments on four different depreciation methods all of which would liberalize existing depreciation practices. The Minnesota Department of Public Service recognizes the Commission's desire to provide carriers with more regulatory flexibility and to thereby achieve substantial cost savings. Despite claims to the contrary, the MN DPS is not convinced that the savings promised by the carriers will ever be realized or that the benefits of any new procedures exceed any accurate measure of their total costs. Thus, the MN DPS advocates that the FCC select the least objectionable of its four proposals, the basic factors range option, and that it apply the new proposal only to minor accounts until the effects of any new depreciation practice can be thoroughly tested and evaluated.

Respectfully submitted,

MINNESOTA DEPARTMENT OF PUBLIC SERVICE

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STATE OF MINNESOTA)
COUNTY OF RAMSEY) ss

AFFIDAVIT OF SERVICE

I, **Linda Chavez**, being first duly sworn, deposes and says:

That on the **12th** day of **April, 1993**, she served the attached
DPS Reply Comments

CC Docket No. 92-296

- X by depositing in the United States Mail at the City of St. Paul, a true and correct copy thereof, properly enveloped with postage prepaid.
- X by personal service
- x by express mail
- by delivery service

to all persons at the addresses indicated below or on the attached list:

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Subscribed and sworn to before me
this 12th day of April, 1993

Carol T. Nelson

